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IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellees.

On Appeal From The Court Of Appeal Of
California, First Appellate District

MOTION OF THE UNION OF INDUSTRIES OF THE EUROPEAN COMMUNITY TO FILE BRIEF *AMICUS CURIAE*

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The Union of Industries of the European Community (Union des Industries de la Communaute Europeenne, hereafter "UNICE") respectfully moves this Court for leave to file in the case now pending, set for argument this fall, the brief *amicus curiae* that it previously filed in the case of *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, Supreme Court No. 81-349, argued this spring. The interest of *amicus curiae* and the reasons for granting the motion are stated below.

UNICE is a confederation of the industrial federations of the ten member nations of the European Economic Community, and includes as associate members the eight national industrial federations of the European Free

Trade Association. Approximately two-thirds of all foreign direct investment in the United States is made through United States subsidiaries of European parent corporations, most of whom belong to a UNICE constituent federation. UNICE thus has an important, substantial, and direct interest in State taxation of its members' United States subsidiaries, such as that imposed by California's unitary tax at issue in this case.

A State's requirement of worldwide combined reporting of income, such as the requirement imposed by California, has a direct and adverse effect on those subsidiaries. However, this impact differs — both in degree and in kind — from the impact on the parties to this case, because those parties are all members of corporate groups with *domestic* parents. Corporate groups with *foreign* parents, such as members of the constituent federations of *amicus*, have a distinctly different treaty and constitutional status, and the application of a combined reporting requirement to them would raise additional and substantially different constitutional, treaty, and foreign policy issues. The brief to be filed by *amicus* identifies these issues, which are not presented by the record in this case or addressed by the courts below, and alerts the Court to the limited nature of the question presented for decision in this case.

Amicus has previously filed its brief *amicus curiae* in *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, Supreme Court No. 81-349, pursuant to the consent of the parties to that case. The constitutional, treaty, and foreign policy issues discussed in that brief apply with equal force to the instant case, since the imposition of California's unitary tax on corporate groups with foreign parents raises the same issues as the application of Illinois' uni-

tary tax to such groups.* The points raised by *amicus* are not addressed by the parties in either case, however, because in both cases no party is a corporate group with a foreign parent.

Amicus therefore respectfully requests the Court to accept for filing in this case the UNICE *amicus* brief previously filed in *Chicago Bridge & Iron*. Forty copies of that brief are submitted herewith.

Respectfully submitted,

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*Obviously, the UNICE brief filed in the *Chicago Bridge & Iron Co.* case will still contain references to appellant Chicago Bridge & Iron Co. rather than to appellant the Container Corporation, and to the Illinois unitary tax rather than the California unitary tax. Other than these two obsolete references, however, the arguments and lega citations contained in the UNICE brief are fully apposite to, and define the limitations of, the issues posed by the *Container Corporation* case.

CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing Motion for Leave to File Brief *Amicus Curiae*, as well as the attached brief, was made on counsel for both parties on June 17, 1982, by depositing copies thereof in the United States mails, postage prepaid, addressed as follows:

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81-523

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QUESTION PRESENTED BY AMICUS CURIAE

When deciding the issue raised below of whether States may apply combined reporting requirements for tax purposes to international corporate groups with *domestic* parents, should this Court also decide the serious constitutional, treaty, and foreign policy issue not presented by this case: Whether States may apply such a tax regime to corporate groups with *foreign* parents?

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BRIEF OF THE UNION OF INDUSTRIES OF THE EUROPEAN COMMUNITY AS *AMICUS CURIAE*

INTEREST OF AMICUS CURIAE

The Union of Industries of the European Community (Union des Industries de la Communaute Europeenne, hereafter "UNICE") is a confederation of the industrial federations of the member nations of the European Economic Community.[1] The federations belonging to UNICE number among their members most of the major industrial corporations in these ten countries.

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[1] The member nations of the EEC are Belgium, Denmark, France, West Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, and the United Kingdom.

In addition, UNICE includes as associated members the industrial federations of the European Free Trade Association. [2]

A substantial majority of foreign direct investment in the United States comes from European sources, the overwhelming majority of which are multinational corporations belonging to a UNICE constituent federation. [3] In 1980, of the total foreign direct investment in the United States of $65.5 billion, European direct investment was approximately $43.5 billion, or about two-thirds of the total. [4] European enterprises own numerous subsidiaries that are engaged in many types of business in most of the States of the United States. Most of these enterprises are also engaged (through affiliated companies) in business activities in Europe and elsewhere throughout the world. UNICE (on behalf of its members) thus represents a large majority of all foreign direct investors in the United States, and has an important, substantial, and direct interest in State taxation of these business entities.

A State's requirement of worldwide combined reporting of income would have a direct and adverse impact on members of *amicus* with subsidiaries located in the United States. As demonstrated below, this impact is different from the impact on the parties to this case, since they are all corporate groups with *domestic* parents. Corporate groups with *foreign* parents, such as members of *amicus*, have a distinct treaty and constitutional status, and the application of the combined reporting requirement to them would raise additional and substantially different issues. *Amicus* files this brief [5] to identify these issues, which

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[2] The member nations of the EFTA are Austria, Cyprus, Finland, Norway, Portugal, Spain, Sweden, and Switzerland.

[3] Hereinafter, the term "member of *amicus*" means any corporation belonging to a federation that is directly or indirectly a member of UNICE.

[4] Bureau of Economic Analysis, United States Department of Commerce, 61 *Survey of Current Business*, p. 47 (August 1981, No. 8).

[5] Letters from all parties to this case consenting to the filing of briefs *amicus curiae* are on record with the Clerk of the Court.

were not covered by the record in this case or addressed by the courts below, and to alert the Court to the limited nature of the question presented for decision in this case.

SUMMARY OF ARGUMENT

I.

As urged by appellant, the Illinois combined reporting requirement is unconstitutional when applied to the foreign members of any corporate group, whether the parent of the group is domestic, such as the appellant, or foreign, such as members of the *amicus*.

II.

Application of State combined reporting requirements to corporate groups with *foreign* parents would raise grave constitutional, treaty and foreign policy issues beyond those raised by appellant:

State application of combined reporting requirements to corporate groups with foreign parents would conflict with existing United States treaties that prohibit burdensome, excessive, or unreasonable taxation. No State has the constitutional power to impose taxes on foreign corporations in a manner that conflicts with existing treaties signed by the United States.

State application of combined reporting requirements to corporate groups with foreign parents would violate generally accepted international tax principles, especially the "arm's-length" principle, interfere with the Federal government's power to negotiate treaties, and invite foreign retaliatory taxation. This direct State interference with the Federal government's exclusive authority to conduct foreign policy is prohibited by the Commerce Clause.

State application of combined reporting requirements to corporate groups with foreign parents would result in interna-

tional — not merely interstate — double taxation, which is unconstitutional under the Commerce Clause.

III.

Because no party to this suit is a corporate group with a foreign parent, these grave, complex and unique constitutional and treaty issues are not appropriately presented by the record in this case, nor were they addressed by the courts below. Should this Court conclude that State combined reporting is permissible for corporate groups with *domestic* parents, the absence of a proper record should cause the Court to reserve judgment on the separate issue of the constitutionality of extending these requirements to corporate groups with *foreign* parents.

ARGUMENT

I. A WORLDWIDE COMBINED REPORTING REQUIREMENT IS UNCONSTITUTIONAL WHEN APPLIED TO ANY GROUP OF CORPORATIONS WITH FOREIGN MEMBERS, INCLUDING MEMBERS OF AMICUS.

UNICE supports and endorses the position of the appellant that the imposition of an Illinois income tax on the apportioned combined worldwide business income of a group of related corporations that includes foreign corporations violates both the Commerce Clause and the Due Process Clause of the United States Constitution. This constitutional violation occurs whether the group's parent[6] is domiciled in the United States, as is appellant, or in a foreign country, as are members of *amicus*.

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[6] As used in this brief, the term "parent" means the corporation or corporations with ultimate voting control over the group of corporations whose "unitary" income is taxed by the State seeking to impose the combined reporting requirement. The term "group" means a group of corporations that has so-called unitary operations for purposes of State combined reporting (although *amicus* does not concede that the States' application of this principle conforms with constitutional, treaty, or tax law principles).

For the reasons stated in the appellant's principal brief, this Court should ban combined reporting requirements of a group of related corporations with foreign members regardless of the domicile of the parent.

II. ADDITIONAL GRAVE ISSUES, BOTH CONSTITUTIONAL AND TREATY-BASED, WOULD BE RAISED BY THE APPLICATION OF A COMBINED REPORTING REQUIREMENT TO A RELATED GROUP OF CORPORATIONS WITH A FOREIGN PARENT.

The appellant herein and the intervenors below are all *domestic* parents of groups of related corporations. Consequently, the validity of a tax on the combined worldwide business income of a group of related corporations with a *foreign* parent has not been adequately presented by this record. These foreign parents and the their foreign subsidiaries may have no operations and no presence in the taxing State or the United States, and may pay no Federal income tax, yet they are subjected to claims for taxes on their income under State combined reporting. UNICE is an association that includes such foreign parents and, as *amicus curiae*, demonstrates below the weighty additional constitutional issues that would be raised by the extension of the combined reporting requirement to corporate groups with foreign parents.

A. The Constitutionality Of Combined Reporting Applied To Corporate Groups With Foreign Parents Is Particularly Suspect Because It Severely Affects Foreign Commerce.

This Court has recognized that the Federal government's power over foreign commerce is greater than its power over interstate commerce, and that the reach of the States' taxing power is consequently more limited when it affects foreign commerce. In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), the Court held that, as between Federal power over foreign commerce and power over interstate commerce, "the scope of the foreign commerce power [is] the greater." 441

U.S. at 448. Similarly, in *Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980), the Court observed that ". . . Commerce Clause scrutiny may well be more rigorous when a [State] restraint on foreign commerce is alleged." 447 U.S. at 438 n.9. This Court's opinions have stressed that foreign policy is preeminently a national concern, in which the States may not interfere.

The Court's decision in *Japan Line, supra*, demonstrates the severe limits this principle places on State taxing power. The State of California sought to levy a property tax on an apportioned part of the value of shipping containers used in international trade. The legal situs of the containers was Japan, which was entitled to and did tax their full value. California argued that its tax applied only to a properly allocable in-state portion of the containers' value, and that the Federal power over foreign commerce was therefore not affected. The Court rejected this argument because of Japan's recognized power to tax the full value of the containers, including California's purported "share;" the Court noted that California's argument "may have force in the interstate commerce context," 441 U.S. at 454, but not in the context of foreign commerce.

Although *Japan Line* involved an *ad valorem* property tax, not an income tax, the constitutional principles and policies enunciated therein are equally applicable to an income tax. When the issue is properly joined before this Court, the principle of *Japan Line* might be held to prohibit a State income tax on the unitary income of a foreign-owned corporate group, because that income is taxable in the country of the parent's domicile.[7]

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[7] This Court has yet to consider the impact of the Commerce Clause on such a tax. The two successor cases to *Japan Line, Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980), and *Exxon Corp.* v. *Department of Revenue*, 447 U.S. 207 (1980), both dealt with the imposition of State income tax combined reporting requirements on the *domestic* parent of a worldwide operation; the issue in each case was the proper method of

Such a result makes sense in light of the serious treaty and foreign policy problems, discussed below, that would inevitably result from the attempted expansion of State income taxation. Members of both the legislative [8] and executive [9] branches of the Federal government have already expressed their support for precluding State application of combined reporting to foreign-owned corporate groups, in effect endorsing the principles and policies that would underlie the application of the *Japan Line* rationale to State income taxes.

In any event, *Japan Line* clearly requires that combined reporting be scrutinized more closely when applied to corporate

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apportioning among the States what was conceded to be "income to the parent," *Mobil Oil Corp., supra*, 445 U.S. at 440, and did not involve a question of double taxation at the international level. *Id.* at 447-48. Moreover, the Illinois Supreme Court, distinguishing *Japan Line* in its opinion below, did not purport to consider the effect of combined reporting on a foreign-based multinational corporation. *Caterpillar Tractor Co.* v. *Lenckos*, 84 Ill. 2d 102, 417 N.E.2d 1343, 1353-54 (1981).

The Court's decision in *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Comm'n*, 266 U.S. 271 (1924), cited in *Mobil Oil Corp., supra*, also involved a different question, since it concerned a single corporation whose branch office operated within the taxing State.

[8] The *Recommendation* of the Task Force on Foreign Source Income, House Committee on Ways and Means, 95th Cong., 1st Sess. (Comm. Print 1977), proposed that foreign-based parent companies be exempted from State income tax combined reporting requirements, and various legislative methods of implementing this proposal have been explored. *See*, e.g., H.R. 5076, 96th Cong., 1st Sess. (August 2, 1979); S. 983, 96th Cong., 1st Sess. (April 23, 1979); S. 1688, 96th Cong., 1st Sess. (August 3, 1979); H.R. 1983, 97th Cong., 1st Sess. (February 23, 1981); S. 655, 97th Cong., 1st Sess. (March 10, 1981).

[9] *State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688 Before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance*, 96th Cong., 2d Sess. 38 (1980) (Testimony of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy).

groups with *foreign* parents than when applied to groups with *domestic* parents. The instant case requires only the latter, less stringent examination.

B. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Conflict With Treaties Between The United States And Foreign Nations.

1. Treaties prohibit States from subjecting foreign corporations to burdensome, excessive, or discriminatory taxation.

The United States is currently a party to some 28 treaties of friendship, commerce, and navigation with foreign nations, and to tax conventions with approximately 59 countries. These treaties and conventions generally contain provisions which, *inter alia*, prohibit discrimination against foreign companies or United States companies owned by foreigners and also, in some cases, restrict taxation to income which is related to or allocable to activities within the United States. [10]

The treaties with the Netherlands [11] are an excellent example. The Netherlands FCN Treaty requires that State taxation meet general standards of reasonableness and nondiscrimination.

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[10] The United States presently has tax conventions with all nations of the European Economic Community and all nations in the European Free Trade Association except Cyprus, Spain, and Portugal. The United States has FCN or similar treaties with all nations of the European Economic Community except the United Kingdom, and with four members of the European Free Trade Association: Austria, Finland, Norway and Switzerland.

[11] Treaty of Friendship, Commerce and Navigation between the United States of America and the Kingdom of the Netherlands, signed at The Hague, March 27, 1956, 8 U.S.T. 2043, T.I.A.S. No. 3942 (the "Netherlands FCN Treaty"); Convention between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes, signed at Washington, April 29, 1948, 6 U.S.T. 3696, T.I.A.S. No. 1855, as amended by the Supplementary Convention, signed at Washington, December 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051 (the "Netherlands Tax Convention").

State taxing authorities must "at all times accord fair and equitable treatment to the nationals and companies of the [Netherlands], and to their property, enterprises and other interests," Art. I, § 1, and are barred from taking "unreasonable or discriminatory measures that would impair the rights or interests" in the United States of Netherlands companies or their subsidiaries. Art. VI, § 3. The Netherlands Tax Convention protects a Netherlands company from taxation of its interests in the United States that is more burdensome than the taxes imposed on a corporation of the United States, the capital of which is wholly owned by citizens or corporations of the United States. Art. XXV, §§ 4 and 5. The Netherlands FCN Treaty prohibits States from imposing taxes more burdensome than those borne by nationals of "any third country." Art. XI, § 3. [12] Finally, the Netherlands FCN Treaty prohibits U.S. taxing jurisdictions from imposing or applying any tax "upon any income, capital, or other basis in excess of that reasonably allocable or apportionable" to the taxing jurisdiction. Art. XI, § 4. Similar provisions appear in other treaties, such as those with the Republic of China [13] and, as noted above, France. [14]

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[12] This obligation imposes more stringent limitations on State taxation by incorporating other treaty restrictions; for example, the Convention of Establishment between the United States of America and France, signed at Paris, November 25, 1959, 11 U.S.T. 2398, T.I.A.S. No. 4625. Article IX limits State taxation of French companies to income "directly related to their activities within those territories."

[13] Treaty of Friendship, Commerce and Navigation between the United States of America and the Republic of China, signed at Nanking, November 4, 1946, 63 Stat. 1299, T.I.A.S. No. 1871, continued in force, 22 U.S.C. § 3303(c), Art. X.

[14] Convention between the United States of America and the French Republic with Respect to Taxes on Income and Property, signed at Paris, July 28, 1967, 19 U.S.T. 5280, T.I.A.S. No. 6518, Art. XXIV; Convention of Establishment between the United States of America and France, *supra*, Art. IX.

As explained below, State combined worldwide reporting requirements subject United States subsidiaries of foreign corporations to taxes and compliance procedures that are unreasonable within the meaning of the treaties and more burdensome than those imposed on United States companies. They impose taxes on income in excess of that reasonably allocable to the State under generally accepted international principles. State application of combined worldwide reporting to a group of corporations with a foreign parent, therefore, conflicts with existing treaties. Under our Federal system, no State has the constitutional power to act in a manner which violates United States treaty commitments.

2. The combined reporting allocation formulas, when applied beyond the homogeneous economy of the United States, distort income and subject foreign parents to excessive taxation, in violation of treaties.

The combined reporting requirement employs an apportionment formula that assigns to the taxing State a portion of the total income of the taxpayer's "unitary business," usually based on factors such as property, payroll, and sales. Implicit in these formulas (and a prerequisite to their validity) is the assumption that the economic environment in which these factors exist is roughly homogeneous throughout the entire area of the corporation's operations. Such an assumption may be reasonable in the case of a domestic parent whose corporate group carries on most of its business within the United States.

When the group has extensive operations in other countries (as most foreign-owned groups do), however, the apportionment formulas can produce seriously distorted results. Differences in wage rates, raw material prices, insurance, and risk will generate "in-state" income figures that bear no rational relation to the proportion of the business actually conducted within the taxing State's borders. Recently, for example, a State taxing authority apportioned to one of over 900 worldwide

subsidiaries of a member of *amicus* an income of $46,000,000 over a four-year period, despite the fact that the subsidiary itself had losses of some $390,000,000 during the same period.[15] This result shows that the combined reporting requirements can produce quixotic taxation when applied to groups with foreign parents.

A foreign parent domiciled in an FCN Treaty country can justly assert that the State tax is being applied to income in excess of that reasonably allocable or apportionable to the taxing State, in violation of Federal treaty obligations.[16] In addition, both a foreign parent and a domestic parent can properly assert, as the appellant in this case has done, that such taxation violates the Due Process Clause of the United States Constitution.

3. Conflicting interpretations of combined reporting requirements by States would result in unreasonable and discriminatory treatment of foreign corporations in violation of treaties.

The unitary method is a way of crudely approximating the portion of a multistate corporation's income that is attributable to the taxing State. Because the result will in any case be only a very rough estimate, States have been allowed, within broad limitations, to devise their own individual combined reporting requirements and apportionment formulas. *Moorman Mfg. Co.*

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[15] This conduct by the State taxing authority is being challenged in a Federal district court as violative of treaties between the United States and the Netherlands, general principles of international law, and the United States Constitution. *Shell Petroleum N.V.* v. *Graves et al.*, No. C-81-4302 (N.D. Cal. filed November 4, 1981).

[16] There will be numerous combinations of State tax law, FCN treaties and tax conventions. The nature and severity of the constitutional issue will therefore depend on the relationship of the specific provisions of the State tax law to the provisions of the applicable FCN treaty and tax convention.

v. *Bair*, 437 U.S. 267 (1978). These variations in State methods can result in inexact apportionment.

While a potential for inexactitude may be tolerable under our broad constitutional principles of Federalism, it is intolerable in foreign affairs. Any meaningful inexactitude is inconsistent with treaty provisions that forbid State taxing authorities from taking "unreasonable or discriminatory measures" with respect to foreign corporations, and from taxing income and profits from transactions that arise outside the United States. [17]

4. The combined reporting requirement imposes on a foreign parent more burdensome tax obligations than those imposed on domestic companies, in violation of treaties.

A foreign parent of a worldwide group of corporations ordinarily keeps its books and records using the accounting systems and currency of its country of domicile. (Indeed, it is often required to do so by the laws of that country.) Compliance with a State combined reporting requirement would present a foreign parent with immense and costly administrative problems that a domestic corporation operating under the United States Federal system of taxation would never face. By virtue of its domicile, a domestic parent already complies with United States tax reporting requirements. In contrast, a foreign parent would be compelled to recompute its entire worldwide income according to accepted United States accounting principles, even though these might (and often do) differ drastically from those required by its country of domicile. It would have to convert its worldwide income into United States dollars, taking into account frequent wide fluctuations in the exchange rates of numerous foreign currencies. [18]

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[17] *Cf. Japan Line, Ltd.* v. *United States*, *supra*, 441 U.S. at 456, discussed below at 21.

[18] Indeed, since many multinationals plan their transactions with currency exchange fluctuations in mind, major corporate strategy decisions would be influenced by the necessity of ultimately converting corporate records into United States dollars for State tax purposes.

For example, a subsidiary of a United States corporation operating in France would ordinarily maintain its records in French francs. The francs would have to be converted into the value of United States dollars in reporting its earnings for United States tax purposes, and there would likely be accounting adjustments because of different accounting principles. But this would end the matter. A subsidiary of a Netherlands company operating in France would also maintain its records in francs, and would have to convert the francs into guilders in reporting its earnings to the Netherlands authorities. Thereafter, however, the Netherlands parent (if it also had a United States subsidiary) would have to convert the guilders to United States dollars (and quite possibly make accounting adjustments) to satisfy the requirements of a State that employed the worldwide unitary system of reporting. If the Netherlands parent has many subsidiaries operating in numerous countries, it and its worldwide subsidiaries would have to go through the whole process of multiple currency and accounting adjustments for each entity. These costly and burdensome requirements would be imposed even on a foreign group whose United States operations represented only a minuscule portion of its total activity.

Further complications are possible. Different States may use different methods of applying combined reporting apportionment formulas, and may require differing methods of accounting for exchange rate fluctuations and other transactions. Thus, a foreign parent corporation could be forced to undertake this process separately for each State in which it operates.

These burdens discriminate against, and "impair the rights or interests of," foreign parent companies. Domestic parents' burdens are not nearly so heavy. Because State tax requirements subject the treaty-protected corporations to more burdensome obligations with respect to taxes than those imposed on domestic parents, they violate the FCN treaties.

* * *

The treaty problems described above are weighty and troublesome, and are viewed with rapidly increasing concern by the United States' treaty partners. On March 19, 1980, and again on October 30, 1981, the ten members of the European Economic Community joined in a *demarche* to the State Department, strongly condemning the States' application of the unitary system to corporations domiciled in their countries and urging a swift Federal remedy.[19] On March 25, 1980, the British Government delivered a note to the State Department summarizing the objections of the United Kingdom to State unitary income taxation.[20] The International Chamber of Commerce issued a Resolution opposing the unitary method on September 26, 1979.[21] *Amicus*, representing multinational corporations of almost all of the major United States trading partners, has publicly stated its firm opposition to the unitary method in an international press release dated February 3, 1976.[22] This question is already a major issue in United States foreign relations with its treaty partners.

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[19] Advisory Commission on Intergovernmental Relations (hereafter ACIR), "State Taxation of Multinational and Multistate Corporations" (Washington, December 4, 1981), at 12-14; 127 Cong. Rec. S 14773 (daily ed., December 8, 1981).

[20] Note Regarding the Unitary Basis of Taxation from the Government of the United Kingdom to the United States Government (March 25, 1980), Appellant's Appendix, I-14-16.

[21] International Chamber of Commerce, Resolution (Doc. No. 180/195 Or. Rev., Sept. 26, 1979), Appellant's Appendix, I-47-48.

[22] UNICE Press Release on Unitary Taxation (February 3, 1976). This press release noted with regret that United States political subdivisions might abandon the internationally recognized system of taxation based on the arm's-length principle and instead adopt a unitary based system: "The fact is that the unitary tax system does not lead to taxation on an equitable basis, as it can easily result in double taxation which it is virtually impossible to cure where international operations are involved. . . . UNICE therefore

Because no party to this case is a member of a corporate group with a foreign parent, this complex treaty issue was not covered in the record below, not raised by the parties, and not addressed by the Illinois courts. It should be expressly reserved for a later decision in an appropriate case.

C. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Interfere With The Federal Government's Ability To Speak With One Voice On foreign Policy And Would Invite Retaliatory Foreign Taxation.

When inquiring into a State tax that directly affects foreign (rather than interstate) commerce, a court must examine whether the tax prevents the Federal government from "speak-[ing] with one voice when regulating commercial relations with foreign governments." *Japan Line, supra*, 441 U.S. at 449. If it does, the tax is unconstitutional under the Commerce Clause. *Id.*

Application of the combined reporting requirement to a United States corporate group that includes foreign subsidiaries may substantially interfere with the Federal government's power to conduct its foreign commercial relations. The interference is far worse, however, when the group has a *foreign* parent. The extension of combined reporting to such a group therefore raises substantial constitutional issues.

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takes the view that as regards the determination of taxable incomes of groups of companies, political subdivisions of contracting states should adopt the universally recognized method based on the arm's length principle."

1. The Federal government would be prevented from harmonizing its foreign policy with generally accepted principles of international taxation, and its ability to negotiate advantageous treaties and accords would be impaired.

There is an existing broad consensus among the international community that the so-called "arm's-length" method[23] of apportioning a multinational taxpayer's income among taxing jurisdictions is the only acceptable approach to the taxation of multinational corporate groups.[24] The arm's-length method is used both by the United States in determining the Federal tax liability of foreign entities, and by foreign nations in determining the tax liability of subsidiaries of United States corporations operating within their borders. Among the developed nations, it appears that certain States in this country are the only major income taxing jurisdictions that have rejected the arm's-length method and adopted the far more intrusive and extensive combined reporting system.

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[23] Under the "arm's-length" method, the profits earned by a taxpayer involving transactions with related entities are determined as though the terms of the transactions were those that would have been agreed on between unrelated parties engaged in the same transactions. This method is the same as that prescribed by section 482 of the Internal Revenue Code, 26 U.S.C. § 482, for Federal tax purposes, and is intended to prevent artificial shifting of income.

[24] *See, e.g.*, Committee on Fiscal Affairs, Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises* (Paris 1979), at 8-9; Surrey, *United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries*, 19 HARV. INT'L. L.J. 1, 53-57, 83-84, 121-22 (1978); the arm's-length method is also prescribed by the OECD Model Convention on Double Taxation as well as the Department of the Treasury's Proposed Model Income Tax Treaty. Organisation for Economic Co-operation and Development, 1977 Model Double Taxation Convention on Income and Capital, Arts. 7 and 9, *reprinted in* 1 CCH Tax Treaties ¶ 151; United States Department of the Treasury, Proposed Model Income Tax Treaty (June 16, 1981), *reprinted in* 1 CCH Tax Treaties ¶ 158.

These States' departure from this broad consensus has interfered with the Federal government's conduct of its foreign affairs and damaged the Nation's standing in the international community. As noted above, some foreign nations consider the application of the combined reporting requirement to their domiciliaries a violation of United States treaty commitments. Clearly, a few States' unilateral actions have prevented the Federal government from "speaking with one voice" on foreign policy matters.

The unitary tax system has also interfered with treaty negotiations, an exclusively Federal domain. A provision dealing with unitary State taxation of corporate groups with foreign parents was a major sticking-point in the negotiation of the recent Convention between the United States of America and the United Kingdom, signed at Washington, December 31, 1975, T.I.A.S. No. 9682. [25] In view of the widespread opposition of foreign nations to State unitary taxation of foreign parents, the issue will in all likelihood be raised with frequency and vigor in future negotiations. [26]

State imposition of combined reporting requirements on foreign based parents necessarily results in a serious State intrusion into our Nation's foreign policy and raises fundamental constitutional issues that cannot be resolved on the record in this case.

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[25] The provision was ultimately dropped, but only on the understanding that a legislative solution to the problem would be forthcoming. *See* S. Ex. Rep. No. 96-5 (June 15, 1979), at 6. As noted above, the United Kingdom subsequently formally protested State unitary income taxation.

[26] *See also* ACIR, "State Taxation of Multinational and Multistate Corporations," *supra*, at 18-19.

2. The United States would face serious risks of retaliatory taxation imposed by other nations on foreign subsidiaries of United States corporations.

As foreign governments become increasingly offended by what they perceive to be unfair or oppressive tax treatment of their corporations by States, the risk of a retaliatory tax on foreign subsidiaries or operations of United States corporations will grow. Foreign nations could find precedent, if precedent were needed, for retaliatory taxation in section 891 of our Internal Revenue Code, which grants the President the right to double the rate of tax on citizens of any foreign nation that subjects United States citizens to a discriminatory or extraterritorial tax.

Any retaliatory tax imposed by a foreign government would almost certainly not be directed only at corporations owned by domiciliaries of the offending States. Rather, the United States as a whole would suffer the international consequences of the unilateral action of a few of its States. As this Court noted in *Japan Line, supra*, this is precisely the type of State interference with foreign affairs prohibited by the Constitution:

> "If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer. If other States follow the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from 'speaking with one voice' in regulating foreign commerce." 441 U.S. at 450-451 (footnotes omitted).

A decision to run such nationwide risks of foreign tax retaliation must be left to the Federal government, not to State taxing authorities whose responsibilities are limited to generating State revenue. Otherwise there would be created a constitutionally impermissible division between the *power* to take actions seriously affecting foreign commerce and the *responsibility* for the results of those actions.

3. The Federal government's power to negotiate mutual restrictions on access to confidential governmental information would be diminished.

Every sovereign nation has the right to control foreign access to information about its economic policies, national defense, and other sensitive subjects. As part of that control, nations ordinarily contract for delicate defense or research projects only with domiciliary corporations. Foreign access to such information is thereby limited.

For a United States parent of a worldwide group, combined reporting does not affect this confidentiality. The taxing authority requiring information about the group's activities is itself a United States entity, and any conflicts that develop can be resolved, if necessary, by this Court.

A foreign parent, however, faces a different problem. From its viewpoint, a foreign nation's taxing authorities are requiring detailed information concerning matters that the corporation is legally and patriotically required to withhold. Furthermore, there is no available forum with jurisdiction over all parties. Foreign nations would understandably resent these State intrusions into their sovereign secrets, and the Federal government's power to negotiate and enforce restrictions on foreign access to its own confidential information would be impaired. Under our Constitution, a State does not have the power to create these disruptions in national policy.

4. The Federal government's attempts to attract, discourage, or regulate foreign investment in the United States would be impeded.

The problems described above discourage foreign investment in the United States. Foreign-based corporate groups become less willing to locate capital in this country, even for limited purposes, as State tax and compliance burdens grow, especially those that affect foreign parents more heavily than domestic parents. Recent treaty negotiations with the United Kingdom and Canada have already revealed an increased concern on the part of foreign governments over the effect of combined reporting on their policies regarding investment in the United States.[27]

The Commerce Clause lodges in the Federal government alone the power to encourage, discourage, or otherwise regulate foreign investment. To the extent combined reporting requirements intrude into this sphere, they are inconsistent with the Commerce Clause, and constitutionally invalid.

* * *

In our Federal system, authority to conduct relations with foreign nations has been given to those responsible for the welfare of the Nation as a whole, not to those whose sole concern is levying and collecting local taxes. As this Court has stated:

> "These are delicate matters. If state action could defeat or alter our foreign policy, serious consequences might ensue. The nation as a whole would be held to answer if a State created difficulties with a foreign power." *United States* v. *Pink*, 315 U.S. 203, 232 (1942).

Extending combined reporting requirements to corporate groups with foreign parents would create just such difficulties.

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[27] Treasury Department Tax Reform Option Paper No. VIII, *excerpted in relevant part in* Appellant's Appendix, Section F; ACIR, "State Taxation of Multinational and Multistate Corporations," *supra*, at 19.

The States' encroachment on the areas of exclusive Federal jurisdiction described above has already been substantial, and has given rise to considerable Federal concern. Several pieces of legislation have been proposed. [28] The Treasury Department, the House Ways and Means Committee, and the Advisory Committee on Intergovernmental Relations have all urged that Federal action be taken to limit the States' intrusion into foreign affairs. This is a complex and delicate issue that must, at the appropriate time, be addressed directly and at length.

However, because no foreign-based corporate group is a party to this case, this constitutional issue was not addressed below, and there is no record to support a reasoned decision concerning it. It is clear, however, that the practice would severely restrict the ability of the Federal government to "speak with one voice" in matters of foreign policy and interfere with the Nation's conduct of foreign affairs.

D. Extending A Combined Reporting Requirement To Groups With Foreign Parents Would Inevitably Lead To Impermissible International Double Taxation.

This Court has held that a State tax that, notwithstanding apportionment, "creates a substantial risk of international multiple taxation . . . is unconstitutional under the Commerce Clause." *Japan Line, supra,* 441 U.S. at 451. This holding reflects the general policy that

> "[e]ven a slight overlapping of tax — a problem that might be deemed *de minimis* in a domestic context — assumes importance when sensitive matters of foreign relations and national sovereignty are concerned." *Japan Line, supra,* 441 U.S. at 456.

The reason for such a principle is clear. As this Court explained,

> "[N]either this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign

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[28] *See* note 8, *supra.*

> sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that 'multiple burdens logically cannot occur,' the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Japan Line*, *supra*, at 447-48 (footnotes and citations omitted).

This Court is available as a final arbiter of any conflicts that may arise among the several States with respect to the proper apportionment of a taxpayer's income. But no tribunal can resolve similar conflicts between a State and a foreign nation. Rather, such conflicts must be resolved by international negotiations that may constitutionally be conducted only by the Federal government.

A Treasury Department study of the States' experience with unitary tax concluded that it results in international double taxation of income because it apportions income on a basis totally different from the arm's-length method agreed to by the major developed nations.[29] Predictably, State tax administrators support the unitary system because it generally brings in higher revenues. When it does so, however, a State taxes income outside of its legitimate jurisdiction, income which has been ceded for taxation to other jurisdictions by treaty and generally accepted principles of international tax law.

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[29] Treasury Department Tax Reform Option Paper No. VIII, *supra*.

Accordingly, a State's taxation of income that may result in double taxation impermissibly encroaches on the power of the Federal government and is a violation of the foreign Commerce Clause of the Constitution. The States' power ends where the Federal government's power begins; indeed, as this Court has stated:

> "If it be otherwise, a single State can, at her pleasure, embroil us in disastrous quarrels with other nations." *Chy Lung* v. *Freeman*, 92 U.S. 275, 280 (1875).

The combined worldwide reporting requirement threatens to do just that, and therefore is constitutionally impermissible.

III. BECAUSE THE RECORD DOES NOT PRESENT THE ISSUE OF THE CONSTITUTIONALITY OF COMBINED REPORTING APPLIED TO CORPORATE GROUPS WITH FOREIGN PARENTS, THE COURT SHOULD NOT DECIDE THAT ISSUE IN THIS CASE.

The record in this case provides abundant support for a conclusion that State combined reporting requirements may not constitutionally be imposed on *any* group of related corporations with foreign members, irrespective of the domicile of the group's parent. If the Court finds for appellant, corporate groups with foreign parents (such as members of *amicus*) will not be subject to State combined reporting requirements, and none of the additional issues described above need ever be addressed.

However, if the Court should conclude that the worldwide combined reporting requirement is permissible for a corporate group with a *domestic* parent, the weighty additional issues that arise when such a group has a *foreign* parent should not be decided in this case, since they have not been adequately addressed by the parties or reflected in the record. These issues should be determined only after a full record has been developed and arguments based on that record are squarely presented for decision.

CONCLUSION

For the reasons set forth above, the Court should hold for the appellant. If the Court nevertheless upholds the validity of imposing the combined reporting requirement on the appellant, the validity of extending that requirement to corporate groups with foreign parents should be expressly reserved for later decision.

Respectfully submitted,

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